Client Update

EU Developments in Uncleared Derivatives Margin Rules

A number of financial regulatory authorities in the European Union have recently published statements regarding the European Union's uncleared derivatives margin rules, which are due to come into effect on 1 March 2017. This update considers the following statements which have been issued:

- a statement by the United Kingdom’s Financial Conduct Authority (“FCA”);¹ and
- a statement by the European Supervisory Authorities (“ESAs”).²

BACKGROUND

The European Union’s margin rules for uncleared derivatives were adopted pursuant to Commission Delegated Regulation 2016/2251 (the “Delegated Regulation”) to implement requirements set out in the European Market Infrastructure Regulation (“EMIR”).³ The rules were finalised on 4 October 2016 and published in the Official Journal on 15 December 2016. The rules impose obligations on parties to derivatives not cleared by a central counterparty in relation to the calculation and exchange of collateral (including an obligation to exchange initial and variation margin in respect of such derivatives).


² Variation margin exchange under the EMIR RTS on OTC derivatives, available at https://www.esma.europa.eu/sites/default/files/library/esas_communication_on_industry_request_on_forbearance_variation_margin_implementation.docx_0.pdf.

³ Regulation 648/2012.
The variation margin requirements under the rules are scheduled to start applying from 1 March 2017 (with transitional periods and later application dates for certain other requirements of the rules).

The industry has been preparing to comply with the rules based on these standards, but the ESAs and the FCA have since been made aware of operational challenges for certain parties to comply with the variation margin requirements by 1 March 2017. Further, a number of global regulators have started to address the concerns of market participants by delaying the 1 March 2017 compliance date.

On 23 February 2017, the International Organisation of Securities Commissions issued a statement recognising that some market participants would not be able to implement well-developed infrastructures to calculate and exchange margin by 1 March 2017, and stating that it was concerned that such participants would not be able to hedge positions. Therefore, it recommended that its members take appropriate measures available to them to ensure “fair and orderly markets” during the introduction and application of the variation margin requirements, given that inability to comply with the requirements could otherwise reduce the ability of firms to hedge positions and adversely affect liquidity.\(^4\)

In the United States, the Division of Swap Dealer and Intermediary Oversight of the Commodity Futures Trading Commission issued a no-action letter to delay the compliance date to 1 September 2017.\(^5\) This was followed by a statement by the U.S. Federal Reserve Board and the Office of Comptroller of the Currency to provide supervisory guidance on the compliance with variation margin requirements by 1 March 2017.\(^6\)

In Japan, the Financial Services Agency of Japan issued a statement acknowledging that there are gaps in implementation schedules of margin regulations among jurisdictions and asked every financial institution to establish

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\(^4\) Statement on Variation Margin Implementation, \(available at:\)

\(^5\) CFTC Letter No. 17-11, \(available at:\)
http://www.cftc.gov/LawRegulation/CFTCStaffLetters/17-11 For more information, see our client update \(available at:\)

\(^6\) Joint Press Release of the FRB and the OCC, \(available at:\)
https://www.federalreserve.gov/newsevents/press/bcreg/20170223a.htm For more information, see our client update available at:
appropriate management systems to implement variation margin, taking into consideration their size and characteristics.

In Canada, the Office of the Superintendent of Financial Institutions issued guidelines stating that it would expect the financial institutions subject to its regulations to prioritize meeting the variation margin requirements with those counterparties to whom they have the greatest exposure in terms of size of both credit and market risk inherent in those counterparty exposures. Financial institutions are expected to meet the variation margin requirements with those counterparties that present a significant exposure by 1 March 2017, and for the other counterparties, the financial institutions are expected to meet the requirements as soon as possible, and in no case later than 1 September 2017.  

THE ESAS’ STATEMENT

The ESAs’ statement makes it clear that they do not have any formal power to delay the application of the Delegated Regulation because a delay is only possible if effected pursuant to legislation. The ESAs, however, expect national competent authorities in the EU to apply their supervisory powers in their day-to-day enforcement of legislation in a risk-based manner, taking into account the size of the exposure to the counterparty. It expects participants to have documented the steps taken towards compliance and put in place alternative arrangements to ensure that the risk of noncompliance is contained, such as using existing Credit Support Annexes to exchange variation margin.

The ESAs made it clear that this statement was not meant to be a “general forbearance” of the Delegated Regulation, but a recommendation for a case-by-case approach by the national competent authorities. They pointed out that the timeline for implementation was known since 2015, and that a delay of nine months had already been granted in 2015 with the “clear expectation that the financial industry would be ready to prepare the implementation within two years.”

THE FCA’S STATEMENT

The FCA welcomed the statements made by the ESAs and IOSCO. It appreciated that some firms may not be in a position to comply with the 1 March 2017 deadline. The FCA would take a risk-based approach and use its judgement as to the adequacy of progress, taking into account the position of particular firms and

the credibility of plans they have made. Noncompliant firms would be expected to be able to demonstrate that they had made best efforts to achieve full compliance and be ready to explain how they will achieve compliance as soon as practicable for all in-scope transactions entered into from 1 March 2017. The FCA expects “detailed and realistic plans” to be in place and may request sight of such plans. In any event, the FCA expects firms to be fully compliant within “the coming few months”.

OTHER STATEMENTS

Various other regulators have also issued similar statements. For example, the Irish Central Bank in its FAQs on EMIR confirmed that it applies a risk-based approach to the supervision of the adequacy of processes adopted by entities and expects all counterparties to make every effort to move into full compliance at the earliest possible date. It is expected that other European regulators will also issue similar statements.

CONCLUSION

Given the difficulties faced by many market participants in executing or amending appropriate documentation governing collateral exchange and management, the statements above are a welcome relief for those participants who have been actively trying to ensure compliance by the 1 March 2017 deadline. However, the statements should not be seen as tantamount to waivers or no-action letters. As made clear in the FCA statement, the authorities will expect firms to have taken steps to comply with the 1 March 2017 deadline and to provide evidence upon request substantiating such efforts.

Firms should therefore ensure that they document their efforts to meet the deadline, including taking advice on how the rules impact them, entering into the necessary documentation and engaging external service providers to undertake the operational processes entailed by the rules if the firm does not have sufficient internal resources for that purpose. Documentary evidence of compliance efforts should be retained and may have to be provided to a regulator, if requested.

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Please do not hesitate to contact us with any questions.